“Asian Private Equity – Will it Deliver on its Promise?”
A Survey of Top LPs and GPs in Asian Private Equity
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For further information on the INSEAD Global Private Equity Initiative (GPEI) please visit www.insead.edu/gpei
1 Executive Summary

This report discusses Asian private equity\(^1\),\(^2\) as an asset class from an institutional investor perspective. It is based on surveys with leading limited partners (LPs) and general partners (GPs) in Asian private equity. The two INSEAD-AXA Private Equity Surveys were conducted from April to June 2010.

The first part of our report offers an introduction to Asian private equity from an LP perspective, starting with a brief summary of its history, followed by a discussion of recent developments in the industry, including the increasing flow of funds into this asset class.

The report then takes a brief look at historic returns and risk (as expressed in return variability) from a portfolio manager’s perspective. We highlight the high variance in returns across the asset class, which makes manager selection the critical element in a portfolio of Asian private equity funds.

The core segment of the report focuses on a selected group of top LPs and their experience with Asian private equity. They have the resources, experience and brand names that allow them to select and (most importantly) access top managers, and hence are best positioned to generate above-average returns for meaningful allocations. Indeed their portfolios are expected to yield gross multiples of around two times invested capital, well above the industry average. We compare their actual returns with their return expectations, specifically the required risk premium over Western private equity, and discuss the performance drivers in their portfolios.

To complement the responses from our selected LPs and to provide a balanced perspective, we extended our survey to a group of top GPs, proposed by our LPs. These represent to a large extent a shortlist of the LP’s portfolios and include some of the most respected names in the industry. As such, they outperform the industry average and LP portfolios as a whole.

Finally, we asked both GPs and LPs about the overall outlook for the industry, and also asked our investors to share with us their portfolio allocation plans.

\(^1\) Throughout the report Asia refers to an area commonly known as Asia/Pacific (which tends to include Australia/New Zealand in the South and India in the West). Not all data sources or respondents necessarily apply the same definition.

\(^2\) Throughout the report we use the narrow definition of private equity that excludes venture capital.
2 Introduction: Asian Private Equity from an LP perspective

This report looks at Asian private equity from the perspective of an experienced institutional investor. As such we allow ourselves to ignore fundamental questions about private equity returns and the benefits of diversification from this asset class, on the assumption that such questions have already been asked and answered to the satisfaction of most institutional LPs.

Equally, we are less concerned with the broad concept of geographical diversification which benefits are theoretically sound although their degree depends on the correlation between Asia and the rest of the world. Asia’s larger economies are increasingly powered by internal drivers, moving away from a predominantly export-oriented model (as in the debate about de-coupling), while many smaller ones often have a limited degree of integration in the world economy in the first place. Therefore investments in Asian markets will increasingly help to reduce non-systematic risks in private equity portfolios.

Rather, we are interested in the (perceived) higher returns for the asset class in Asia and the implied risk premium over mature Western private equity. In making this analysis, we look at how top LPs and GPs perceive the risk of Asian private equity, the historical returns they have achieved, and their expectations of risk and returns in the future. From an institutional investor perspective, we also consider the practical issue of whether this asset class is able to absorb a substantial amount of capital and put it to work meaningfully. Altogether, we look at the question of whether Asian private equity as an asset class has matured.

The discussion about Asian private equity mirrors (and is often confused by) the general theme of the rise of Asia in a wider economic and political context. With the generally positive direction of Asia’s development largely undisputed, it is pricing that regularly causes concern. Unfortunately, high economic growth does not ensure high investor returns. Investors who chase returns in rapidly developing countries are often “[…] paying a price that reflects the growth that everybody can see.”

To help the reader differentiate between these two developments we begin this report with a chapter on the history of Asian private equity charting the ups and downs over the last two decades up to its current standing, once again attracting strong investor interest.

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3 Organisations that pool large sums of money and invest those sums in a wide range of asset classes. These chiefly include pension funds, insurance companies, foundations and endowments, banks and providers of investment vehicles (including mutual funds, fund of funds and hedge funds).

4 While there is considerable debate about the performance of private equity [see, as an example, a recent study by Gottschalp (August 2010) which finds average buy-out performance “only” to be in line with similar public market investments, while top quartile buyout funds show a substantially higher absolute performance including significant alpha] institutional investors on average have an allocation to private equity of between 2.6% (insurance companies) and 8% plus (family offices, foundations and endowments), The City UK, Private Equity 2010 (August 2010).


6 Elroy Dimson quoted in WSJ (15 July 2008).
2.1 A short history of Asian private equity

The Early Days

Private equity in the form of investments in private companies has existed in Asia for decades, yet financing tended to come either from wealthy families or banks, often in unique situations, and thus lacked the institutional quality of fund-based PE in the Western world.

Institutional private equity arrived in Asia in the early 1990s, following the explosive growth of the industry in the US. With record returns generated from US equity markets, institutional investors were on the lookout for new opportunities. Asia (and emerging markets in general) seemed like an attractive area for the tried-and-tested private equity business model, and attracted early investors looking for portfolio diversification and the opportunity to earn exceptional returns.

This development was part of a broader trend of foreign direct investment flowing into Asia, which grew at a compound annual growth rate of 19% between 1992 and 1998. Yet only a relatively small number of large firms had access to bank financing, hence the demand side for private equity looked very strong. The context for investing not only looked attractive from a macroeconomic growth perspective but also thanks to a more receptive attitude to the private sector in general. Supply followed, with about 500 Asian (Ex Japan) funds raising more than $50 billion in new capital between 1992 and 1999, almost all of them for the first time.

Yet the performance of most of these funds turned out to be poor both in absolute and relative terms. Reasons cited were low standards of corporate governance, limited access to quality information both for pre-investment decisions and performance monitoring, weakness of legal systems in enforcing contracts and protecting all classes of investors, a lack of exit prospects, and on the investor side general inexperience and poor quality of fund managers (perhaps not surprising given the scarcity of individuals with relevant experience). The Asian financial crisis exacerbated these problems by bringing huge macroeconomic contradictions to light, leading to a rerating of emerging markets risk and wild currency swings, and subsequently reducing the opportunity for divestments to a trickle. In fact, divestures in 1998 and 1999 averaged about $2.5 billion per year, a small portion of the $35 billion invested between 1992 and 1999.

Figure 1: Dragonair as an Example of Early PE Investing in Asia

Dragonair was started in 1985 with financing and support from the Chao family (a well-known Hong Kong family with a background in the textile industry) and a group of other Hong Kong tycoons to establish a second, more China friendly, carrier in the city. The family sold most of their stake in 1990 to a group of Citic Pacific, Swire Pacific and Cathay Pacific (itself controlled by Swire).
After the Asian Crisis

The end of the 1990s saw growth in two pockets of the industry, namely distressed debt investing (post-Asian financial crisis) and the global technology boom.

Distressed assets in Indonesia, Korea and Japan were a prime target for investors and subsequently generated good returns. For instance, Goldman Sachs tripled the $500 million it invested in Kookmin Bank in 1999, while Ripplewood’s buyout, restructuring and flotation of Long Term Credit Bank in Tokyo (since renamed Shinsei) – which yielded a more than six times return – attained legendary status in Japanese finance.

**Figure 2: Cover of Business Week (Dec 01) celebrating Tim Collins from Ripplewood for the LTCB deal**

Shinsei became Japan’s first foreign-owned bank after a consortium led by Ripplewood bought its bankrupt predecessor, Long Term Credit Bank (LTCB), which had collapsed under a pile of bad loans, in 1999. After a successful turnaround (helped by the government’s assumption of much of LTCB’s bad debt) the restructured company re-flotted in 2004 earning Ripplewood and its partners about $6 billion in profits. While perhaps the most lucrative PE deal in Asia it subsequently led to strong criticism of the Western buy-out model and a regulatory backlash.

Beyond these, most of the investment efforts during this period were directed towards early-stage venture investments, many in South East Asia. However, the lack of industry maturity resulted in poor quality deals being executed in the region. Moreover, the technology crash of 2000/01 resulted in a flight of capital to more conservative investments in ‘old economy’ companies. The poor performance of mainstream private equity (excluding distressed investing) led to a number of early institutional investors withdrawing from the market.

Promise of Returns

After 2001, most deals in Asia were expansion capital or mid-sized buyouts. This period saw the arrival of large international investors. A number of good quality domestic investors also blossomed. This was truly a transition period for Asian private equity, as these early investors educated the business community on the value of private equity investments, lobbied various governments for regulatory reforms, and worked hard to demonstrate returns on their investments. New countries such as China, India and Vietnam opened up to international private equity in Asia – today they attract the lion’s share of the private equity capital flowing into the region.

Ironically, the poor fundraising of the early 2000s (Asian funds excluding Japan had their worst fundraising in 2002 since 1993⁹), coupled with strong market conditions over the years prior to the global financial crisis of 2008, enabled many Asian funds (especially of 2002-2003 vintage) to report internal rates of return (IRR) – compound returns accounting for inflation and currency fluctuations – of at least 20-30%, numbers similar to those seen in the US and Europe.

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⁹ Asia Private Equity Review, 2002 Year-End Review
2.2 Asian Private Equity Today

The general macro-growth of Asian economies and strong returns on deals from the early 2000s has resulted in renewed interest in Asian private equity and a massive inflow of capital.

Over the last 15 years, Asian private equity funds under management increased nine-fold, from US$30 billion in 1994 to about US$283 billion in 2009. About 60% of that amount was added during the last five years alone.

Following several strong years of investing, fund raising peaked in 2008, with over US$50 billion of capital raised, while the investment pace remained high with US$44 billion invested in transactions across Asia Pacific. Yet in the wake of the global financial crisis, sentiment changed towards the end of the year and 2009 reflected a more sober mood, with fund raising and investment dropping by 55% and 57% respectively.

This drop was very much in line with a global meltdown in private equity activity worldwide, starting in the second half of 2008. Developed markets’ private equity was dramatically impacted by the drying up of credit as leveraged buy-outs rely on large amounts of cheap debt. Only one deal in 2009, the take private of IMS Health Inc. for $5.2 billion, comes close to the mega deals of prior years. So despite the strong drop in activity, Asia nevertheless increased its share of global private equity investment to around 13-14%, from a historic level of 5-7%.

Figure 3: Asian Private Equity Pool - Aggregate (in US$ bn)

Figure 4: Asian Private Equity Capital Raised & Invested (in US$ bn)

Figure 5: Asian Private Equity Share of Global Private Equity Invested (in %)

10 Unless otherwise stated, all data in this chapter come from Asian Private Equity Review (APER)
Paradoxically, Asian private equity (excluding venture capital) as a portion of GDP and M&A activity is now on par with or higher than in Western economies.\textsuperscript{11} However, this is less a reflection of tremendous growth in Asia but of a steep decline in private equity penetration in Europe and the US.

Between 2006 and 2009, the majority of funds invested in Asia targeted China, Japan, India, Australia and South Korea. As the largest economies in Asia Pacific, they accordingly received the largest share of the funds flowing in. We can observe how, over time, money started to favour developing Asia over the developed markets. This shift was exacerbated to a certain extent by the typically higher proportion of buy-out deals in developed Asia that dried up during the financial turmoil in 2009 due to their reliance on debt.

The single most critical driver of private equity in Asia since the financial crisis has been the recent track record of successful exits by domestic and foreign investors. The exit environment has improved as public markets have become more efficient and the popularity of IPOs with local investors has increased. While investment activity remained weak, exits showed a remarkable recovery in 2009 (the third highest divestment amount since 2004). This was very much a result of resurging capital markets in the second half of 2009, which were the preferred exit route for private equity portfolio companies with a share of more than 45% of exits. Besides the high share of Japanese divestments (more than half of it from the sale of Sanyo Electric), landmark exits in India and China have particularly reassured investors about liquidity and the potential for success in these markets.

\textsuperscript{11} Bain & Company (2010). Asia Private Equity Market Overview, Presentation.
2.3 A larger slice of the global PE pie

Is the rapid increase of Asian private equity activity over the last decade truly such a unique growth story? Data shows that Asian private equity assets under management (AUM) have indeed been growing at 14% annually since 2000 and even faster in recent years.

**Figure 9: Asian PE AUM (in $bn) as % of Global PE AUM**

Impressive as these numbers may be, comparing them with global PE growth rates reveals that Asian PE merely participated in the unprecedented boom of the private equity industry worldwide.\(^{12}\)

AUMs in Asia maintained a fairly stable proportion (in percentage) of global private equity. Having said that, since the low of 2007 (9.5%), the growth rate has started to gain momentum.

The driving force behind this acceleration appears to be the mainstream opinion that emerging markets – among them China, India and other Asian countries – will be the most attractive investment destinations going forward. In line with this view, LPs expect to strongly expand their allocations to Asia. This leaves a lot of room for growth, as currently just under one-third (32%) of investors from Preqin’s Investor Intelligence database of limited partners have considered or will consider Asian fund commitments.\(^{13}\)

**Figure 10: LPs on Most Attractive Emerging Markets (left) & Planned Changes in Investment Strategy (right)**\(^{14}\)

However, investors frequently raise concerns about the impact this new money will have on GP selection (Will too many second and third tier firms be funded?) and on subsequent returns (Will this lead to a wider dispersion between top firms with impressive returns, and the risk of large losses on the downside?)

So, do historic returns justify the overall optimism for Asian private equity, and how do top investors select the winning managers in a market flush with liquidity?

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\(^{12}\) Asian Private Equity Review and IFSL research

\(^{13}\) Patrick Adefuye, Preqin on 17-Aug-2010, Limited Partner Interest in Asia

\(^{14}\) Preqin (Private Equity Investor Survey, Feb 2010) and Coller Capital & EMPEA (2009)
Private equity is still a fairly young asset class in Asia. In 2000, the industry had no more than $87 billion under management, with a sizable portion in Japan, so any analysis of long term returns will only incorporate a fraction of the cumulative capital raised so far and of the current players in the industry. Equally, short-term returns in private equity are not yet meaningful given the immaturity of investments and the high impact that fees (over committed capital) have on drawn-down capital (J-curve effect). We ask the reader to be mindful of these constraints before drawing any conclusions.

### 3.1 Historic returns

In absolute terms, the 10y net return of Asian PE stands at 7.3%. This is less than half of the dollar-denominated return for European PE, yet on par with PE in the US. The more recent performance shows a positive trend, especially in comparison with Western PE performance, where Asian PE performance is starting to close the return gap at the five-year horizon and substantially outperforms Western PE thereafter.

However, as in the case of Western PE, but even more so, recent (1y) performance seems to be driven by strongly rebounding public equity markets, both for re-evaluation of the portfolio as well as exiting of investments. From a long-term perspective it is not clear that the industry average has generated a substantial risk premium over public equities, as seems to be the case in Europe and (despite its rather unimpressive performance in absolute terms) the US.

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15. The source for all PE return data in this chapter is Cambridge Associates (CA) as of 31. Dec 2009. CA provides IRRs (net of fees, expenses and carried interest) based on cash-on-cash returns over equal periods, modified for the residual value of the partnership's equity or portfolio companies' net asset value (NAV). As for the different geographical indices the Asian PE index includes Venture Capital funds unlike the Western Europe and US indices; the latter, however, includes mezzanine and specialty funds. All indices are pooled, meaning they are producing a dollar-weighted return.

16. For the indices, we used the MSCI Asia ex Japan for a wider Asia Pacific plus India coverage. The Japanese index is shown separately for reference only. For the US, we picked the Russell 2000 as it focuses on mid-size companies more in line with typical PE investment sizes while for Europe we used the broad MSCI EMU index.

17. IRRs cannot be directly compared to returns in public markets as IRRs neglect money held in reserves to honour capital calls, plus assume a reinvestment rate at IRR. So we use public market indices for illustration only, and do not wish to infer a simplistic over- or underperformance of PE vs. public markets. Also, any calculation of “alpha” would need substantial adjustment for type of companies, operating and financial leverage, irregular timing of cash flows in PE and other factors.
3.2 Historic variance (risk)

Another difference between Asian and Western private equity is the significantly higher variance between investment managers.

**Figure 13: Variability of Global PE Returns in IRR %**

Variability (here represented by standard deviations for vintage years) has on average been around 13-15% IRR for Western PE compared to 23% for Asian PE for the eight years up to 2005.

Prior to the financial crisis, the variability of Asian PE returns, as measured in % of IRR, showed a clear downwards trend.

**Figure 14: Asian PE Returns by Vintage (arithmetic mean) vs. Variability**

If we contrast this variability with the returns for Asian PE, we see how closely the two lines follow each other, highlighting the close connection between increased risk (variability) and return. This holds until recent vintages, where the relationship unties. This could be due to recent data being less meaningful (see caveat at the beginning of the chapter) or potentially due to the bull market and subsequent financial crisis, when risk and return disconnected.

If we express variability as a percentage of the average return, then the average variability in Asian PE returns until 2005 was about 180% of the mean return compared to 90-130% for European PE and 110% for US PE.

So, from a portfolio manager’s perspective, Asian private equity is far riskier than Western PE. Compared to public markets, this variability matters more in PE as portfolios tend to be relatively concentrated due to their high screening and monitoring needs.

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18 The fine dotted lines here and in later graphs refer to data points with an insufficient number of funds in the vintage year sample (in this case 2002) to produce robust return/variability numbers.
19 Arithmetic mean by vintage years.
20 Depending on reporting currency.
21 On restrictions in diversifying Private Equity portfolios and the determination of the “right” number of funds in a portfolio see Diller & Jaeckel (2010)
In line with the above analysis, there is currently a wide performance spread between the average performance of the asset class and top and bottom managers (often referred to by their relative position as top and lower/bottom quartile\(^22\)). Indeed, top quartile managers in Asia have in recent years outperformed top quartile managers in Western PE markets.

To summarise the discussion, historic returns for this asset class in Asian have neither been outstanding nor disastrous; in fact they have improved over recent years (both in absolute terms and relative to Western PE), offering a positive outlook for expected returns. However, standard deviations of returns (risk) are high, with top quartile fund managers performing very well in absolute terms.

Success clearly depends on manager selection skills. The nature of the industry makes selection a daunting task. There are few indicators of the potential to outperform, such as longevity of the core team, investment experience, or well-publicized prior performance,\(^23\) yet given the short fundraising cycles, investors (unlike academics) cannot wait for the end-of-life performance of a specific fund but have to base their decisions on intermediate performance. Without a liquid market providing a pricing mechanism, this performance assessment is left to the fund managers’ individual discretion; in reality, GPs perform valuations infrequently and differently from each other.\(^24\)

For the purpose of the INSEAD-AXA PE Survey, is not an attempt to showcase the average performance of the asset class, nor does it try to identify top quartile/decile performance ex post. Instead, we concentrated on the most sophisticated institutional investors (LPs) and their real-life portfolios with the managers (GPs) they selected and who, by definition, will strongly influence their performance for years to come.

We wanted to hear about their real-life investment experiences in Asian PE, review their long-term returns in this asset class for large allocations, and, by extension, determine whether sophisticated investors can achieve above average returns in Asian PE.

\(^22\) Upper/lower quartiles are the thresholds for the upper (top 25%) and lower (bottom 25%) quartiles based on the individual fund IRRs included in a vintage year.

\(^23\) For a discussion of “performance persistence” (i.e. a statistically significant positive correlation between the performance of a PE fund and the performance of the previous fund managed by the same fund manager) see Kaplan & Schoar (2003) and Phalippou & Gottschalg (2009).

\(^24\) This again became very obvious in the recent downturn when portfolio companies with multiple PE investors (club deals) were sometimes valued dramatically differently.
4 The Study

4.1 Approach and Survey Design

The INSEAD-AXA Asia PE Survey explores the following question: Has Asian private equity grown into a viable investment category for “sophisticated” institutional investors?

We selected a shortlist of 30 top investors (LPs) in Asian PE based on assets allocated to the region, length of exposure to Asian PE, their brand name and peer suggestions. An attempt was made to ensure a broad diversification across investor types, to include family offices, sovereign wealth funds, pension funds and a selection of the funds of funds active in the region. The LPs interviewed represent about $100 billion in global AUM, with $9.4 billion in Asian commitments.

We complemented the feedback from our LPs with a survey of 50 “best-in-class” GPs, selected based on the following criteria: LP recommendation (thereby implicitly taking into account performance), brand strength, fundraising capabilities and longevity of the firm. Again, we targeted a balanced mix, this time by geography and investment strategy. The GPs that reverted with relevant data have more than $34 billion in Asian funds. Between 2002 and 2010 - the era of modern Asian PE, post-Asian crisis and technology bubble - these GPs raised over $26 billion, or 13% of all funds flowing into Asian PE ($191 billion in total).

To present our findings in a cohesive framework, we begin with the results from the LP survey, and then complement them with the feedback and viewpoints from the GP survey.

As for any research – but especially when dealing with emerging markets – we had to accept a number of data constraints. These impacted some questions more than others. Wherever our data sample did not reach the required depth (typically a double digit number of answers was the required hurdle) we highlighted its limited nature. Furthermore, given the sensitivity of private equity players to disclosing specific return data, we either asked for data across a portfolio of funds/companies, or provided ranges to be chosen. For instance, we asked LPs to place their fund holdings into performance brackets. This approach requires us to determine certain parameters, e.g., which point in the range to use (typically mid-point), how to weight the amounts invested (either dollar-weighted or equal) etc., which in turn create some variability in the potential outcomes of our findings.

Our study, as it stands, does not claim to provide a conclusive answer on the viability of Asian PE, which would require first-hand deal-data analysis to start with, but offers unique and solid insights into the views of sophisticated PE players (both LPs and GPs) on the development of this asset class. From the outset, we accepted the constraints inherent to emerging markets data. Despite this challenge and in light of the increasing attention given to Asian PE, we felt that a baseline attempt was needed to address the concerns of LPs. It is our goal to revisit this study every 24 months, since its true value clearly lies in the observation of developments over time.

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25 More details on the breakdown of the respondents are provided at the end of the report.
4.2 Return Expectations

We begin our analysis with a look at the return expectations of our LPs. We asked them to share their expected returns for the Asian private equity allocation (both developing and developed Asia) and how these translate into risk premiums compared with PE markets in the West (US and Europe).

Results are as follows.26 On average, LPs expect about 1.95x gross multiple return27 from Western PE. (A number of respondents have lower expectations, while some are looking for 2.5x).

LPs expect little or no risk premium for developed Asia PE, with a few exceptions, looking for a small 1-1.5% IRR risk premium. Accordingly, most LPs expect developed Asia PE to return 2.0x gross multiple.

In the case of developing Asia PE the targets are quite different: a significant risk premium of on average 0.65x (no less than 0.5x and up to 1.0x) is expected. This leads to return expectations among the majority of respondents of 2.5x money (with an average of 2.6x due to some LPs expecting a full 3.0x return).

As several LPs do not differentiate between developed and developing Asia in their portfolios (at least not explicitly) we also asked about risk premiums for overall Asian PE vs. Western PE.

Most respondents expect a 1-5% IRR premium (i.e. 0.1-0.5x money multiple) for Asian PE, which is in line with the above analysis considering the individual LP’s starting point (i.e. their expected returns on Western PE) as well as their implicit portfolio split between developed and developing Asia.

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26 We received answers both for money multiple and IRR (in %) returns. To make them comparable we used the approximation that a 1% IRR equals 0.1x money returned. This holds reasonably well if one takes a 4 year deal investment horizon in the return range (1.5-3.5x) we are looking at.

27 Gross money multiple refers to returns before management fee, expenses and carried interest. For an unrealised fund/investment it equates to Net Asset value (NAV). A rough bridge between gross multiples used throughout the surveys and net returns discussed in previous chapters looks as follows: assuming a 20% carried interest, a 2% management fee on commitments during the investment period and 1.8% on cost thereafter, then a 2.1x gross multiple equals a gross IRR of 20% (over 4 years) a net multiple of 1.6x and net IRR of 14.2%.
Clearly, there is wide agreement between the leading LPs and GPs on what constitutes an adequate return for Asian private equity (i.e., LPs were asked about their expectation as per the above, and GPs about what they thought LPs would expect).

While there is some variance in the responses, the average gross multiple returns for developing and developed Asia are identical, showing good communication between LPs and GPs on this issue.

Of course, there is a feedback loop between what LPs and GPs have seen historically in their portfolios (more on this in the next chapter) and what they think is the “right” expected return.

**Summary Findings**

- LPs expect returns of about 2x gross money multiple for developed Asian PE, similar to Western PE.
- A significant risk premium of on average 0.65x money multiple is expected for developing Asia PE. This translates into a return range of 2.25-3.0x money multiple.
- There is broad agreement between LPs and GPs on what constitutes an adequate return on Asian private equity.
4.3 Historical Returns

Historical Returns for Portfolios

How do the actual returns stack up against these expectations?

Our LPs expect their current portfolios to yield on average a 2.1x gross multiple, a return rate that shows very little variance (between 2.0 and 2.3x). Considering that these portfolios typically cover all of Asia, depending on the allocation split between developing and developed Asia, returns are just short of the expected “right” return for the risk.

Figure 19: Expected Returns of GP Funds by Performance Brackets (LP portfolio)

We cross-checked the answers with the more detailed data that LPs provided on the mature funds in their portfolios and observe that the GP funds’ performance is fairly symmetrically distributed around 2x. As for aggregate expected returns, the uncapped performance of 3x+ funds offsets the higher number of downside capped funds, with returns between 0-1x.

So if we assume mid-range points for the performance brackets and equally weight the dollar fund sizes, then expected returns for our LPs’ portfolios indeed average at 2x gross multiple. Taking higher and lower end points for the performance brackets, the range extends from 1.6 to 2.3x.

Figure 20: Calculated Expected Portfolio Mid-range Returns by Performance Brackets (LP portfolio)

While the average confirms the self-evaluation, there is still a wide variance amongst the LPs surveyed. Keeping in mind that virtually all LPs expect their portfolio to yield >2x, the distribution of LP portfolios (while centred at 2x) is rather wide. There are a number of portfolios that will substantially underperform or outperform the 2x benchmark (independent of what actual point is assumed for the performance brackets).

We now take a closer look at historic returns by geography, strategy and vintage.

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28 When we talk about expected returns this includes for most funds (but the fully repaid ones) a portion of realised returns and of live investments together forming the Net Asset Value (NAV) of the fund/portfolio.
29 We define mature funds as either minimum 4 years old or >70% invested.
30 As expected returns/NAV for our “best in class” GPs (from the GP survey) are higher, averaging 2.3x, with a strongly left shifted distribution.
31 Mid-range points mean, for instance, 1.5x for the “1x to <2x” return bracket. We used the higher point of 0.8x for the below <1x performance bracket to account for the more uneven distribution in the lowest bracket.
Historical Returns by Geography

How do the actual returns stack up against these expectations?

Returns of funds in the LP portfolio are depicted below. Assuming midrange points for performance brackets and equal $ weighting. Unfortunately, only data on China, India and Pan-Asian Funds can be regarded as relevant, with significantly more than 10 funds from each of these geographies included in the sample.

Figure 21: Expected Returns by Geography (left) and Distribution of Pan-Asian Funds (right) (LP portfolio)

With China and India showing strong expected returns, it is interesting to look at Pan-Asian funds in greater detail, given that LPs in our survey have on average more than 40% of their dollars in a third of their funds allocated to them. As shown above, the average performance of a wide sample of Pan-Asian funds is 1.6x. Yet we note a wide performance variance, with a substantial 32% of funds currently not expected by their LPs to return investor capital.

Looking at the geographical performance data from our top GPs, the picture is naturally different. In terms of dollars invested, Greater China and South East Asia are the best performers. Yet in the case of China, the result is slightly skewed due to two very large funds that performed exceptionally well, thereby pushing the average up significantly. If one looks at performance by fund numbers, Greater China funds move closer to the average, and funds from Australia/New Zealand and South East Asia are the most attractive. Pan-Asian funds show the highest probability of a big winner at 40%, but also a high incidence of low performance.

Figure 22: Expected Fund Returns by Geography (GP direct) in $ (left) & by Fund Numbers (right)

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32 Assuming midrange points for performance brackets and equal $ weighting.
33 Sample sizes are balanced for all geographies yet overall fund numbers for each geography are low (5 to 10).
Historic Returns by Investment Strategy

When asked about historic returns by investment strategy, the answers from LPs and GPs are less aligned.

**Figure 23: Expected Fund Returns by Strategy (LP portfolio)**

First, we take a look at the mature funds in the LP portfolios. The distribution of expected returns for growth funds is more left-skewed in the graph (meaning better-than-expected returns) than that for buy-out funds.

This translates into average returns (once more applying mid-range estimates for performance brackets) of 2.2x money for growth funds and 1.7x money for buy-out funds. Again, it is the relatively large number (26%) of buy-out funds (often Pan-Asian funds) which are currently not expected to fully return their capital that stands out.

For our GP survey we added a third category of investment strategy and labelled it “agnostic”. It refers to GPs with no preference for either buy-out or growth investing, indifference to the size of the stake acquired (majority or minority) or the deal structure used (with or without leverage). As it turns out “agnostic” is the largest category in terms of dollars invested.

**Figure 24: Expected Fund Returns by Strategy – left in % of funds, right in % of $ invested (GP direct)**

As the graph shows, funds invested are evenly split in terms of return brackets between 1x and 3x+. Of all the strategies, agnostic funds show the strongest performance, with buy-out funds also valued highly/returning substantial capital. Growth funds show a considerably wider range of outcomes, with more than 50% of growth funds (by numbers) returning less than 2x money.

The data clearly highlights the following points: first, there are numerous buy-out funds with performance above 2x, and, second, our LPs have not been very good at picking them. Furthermore, performance of pure growth funds in the GP survey is markedly worse than in the LP survey, leading to the hypothesis that LPs classified many strategy agnostic funds as growth funds, while these funds in fact frequently go for buy-out structures (with controlling influence) when available.

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34 The percentage of control deals for strategy agnostic funds in our survey ranged from 14% to 80%.
Historic Returns by Vintage

We need to emphasize that our surveyed LPs started to invest in Asian PE on average only in 2001. As a result, we do not have sufficient funds of earlier vintages to draw conclusions from. The GP data is deeper, provides more opportunity for detailed analysis and is therefore a better starting point.35

Figure 25: Returns by Vintage (left in % of funds, right in % of $ invested) (GP direct)

Vintages prior to 2000 (by now fully realised) show a large number of funds (60%) reporting merely satisfactory gross returns of 1-2x, with fewer funds displaying above 2x and 3x. Over the next two vintage groups, performance improves markedly (although some funds losing money appear in the 00-02 vintage). The last batch of vintages again shows lower returns but (given its tender age) consists largely of unrealised investments which tend to be valued conservatively.

In terms of invested capital, the picture is slightly different. In the vintage group prior to 2000, 51% of capital invested returned more than 3x. This means that larger funds outperformed during that period. This effect persisted (albeit to a lesser extent) in the 00-02 vintage group and disappeared thereafter. It is interesting to ponder the impact this development might have had on an investor, as illustrated below.

Figure 26: Illustration of Returns of 1997-99 Vintage

Assuming you missed out on only two out of ten funds between 1997-99, maybe based on an investment hypothesis that larger funds were less relevant in the environment at that time, you would have missed out on 68% of the returns,36 and your portfolio would have returned 1.75x invested capital instead of 2.65x

It is worth reminding the reader that our survey respondents represent a subset of the most successful GPs in Asian PE. In fact, when allocating money in the late 1990s, LPs had a much larger group to choose from and very little data (historic performance, reputation, long-term relationships) to support them.

35 However, we group vintages in three-year clusters to achieve a meaningful sample size.
36 As we don’t have exact fund performances, we use the mid-range for the performance bracket provided in calculating the return.
The above example illustrates that selective investing in private equity, similar to stock picking, will not bring the desired returns. There is rarely sufficient information to base decisions on (esp. in emerging markets) and no economical way to correct selection mistakes quickly by selling the fund allocation. Investors will achieve better and more consistent returns when following a dedicated and long-term investment programme that diversifies between strategies, vintages and geographies.

**Figure 27: Returns by Fund Generation (left) and Average Time between Fundraising (right) (GP direct)**

In addition to our analysis across vintages, we also looked at the evolution of fund generations in Asian private equity. The average fund prior to 2000 (funds -3) returned 2x money, a respectable outcome given the challenges of the Asian crisis and tech bubble that fall squarely into this fund’s lifetime. Yet against a backdrop of slow global fund raising, this allowed GPs to “only” maintain their fund size in the next fund raising round. However, for the two subsequent generations the average fund is expected to return 2.5 and 2.3x capital, enabling GPs to increase average fund size by 2.3 and 2.7x during each fund raising cycle. (Several funds grew more than 4x!). This is a rapid growth of assets under management and may be an indication of the scarcity of good managers in Asia, allowing GPs with good track record to attract a disproportional share of new funds.

Not only have fund sizes increased strongly but also fund raising cycles tended to be rather short for our GPs, with about three years between funds. Considering that usually more than 75% of capital needs to be deployed before fund raising can commence (which itself typically takes more than a year) funds managed to invest their capital allocations quickly.

**Summary Findings**

- Our LPs expect their current portfolio to yield on average a 2.1x gross multiple, just short of the expected “right” return for Asian PE mentioned earlier.

- LPs have allocated substantial capital to Pan-Asian funds. While there are numerous strong performing funds in the GP sample (albeit with a wide distribution of returns), they seem underrepresented in the LP portfolios, resulting in below-average returns for this group in our investors’ portfolios.

- There is no clear pattern of returns by strategy or vintage; the findings support the need for a long-term and well-diversified portfolio programme.

- Backed by strong performance, the GPs in our survey have raised increasingly larger funds (growing about 2.5x over the last two fund generations) within a very short time frame.
4.4 Return Drivers

The generic top-level return drivers in private equity are profit/cash flow growth\(^{37}\) (derived from either revenue growth or margin improvement or both), debt repayment (increasing the value of the equity) and multiple expansion (referring to the increase in enterprise value between entry and exit of the investment as a function of an underlying financial metric – commonly EBITDA multiples or P/E are used).

It is interesting to compare the perceived (in the case of LPs) and real (in the case of GPs for their funds) composition of returns by drivers in different geographies. Very noticeable is the LPs’ perception of high returns due to multiple expansion in China and India, which is much lower in the actual GP funds. Equally LPs perceive a very high debt component in developed Asia and Pan-Asian funds, which is equally significantly lower in the GP funds. In contrast GPs highlight the growth of operating profitability, either due to top line or margin growth or both, as their main return driver.

Allow us to re-iterate that there the funds in our LP portfolios and those covered in our GP survey are not congruent, so it is plausible that the on average better performance reported by our GPs was achieved due to their superior operating skills; alternatively, they might have picked companies with better operating prospects. At the same time, a certain spin by GPs (operating performance currently being valued “higher”) or a perception gap on the LPs’ side (as being one step more remote) are also likely partial explanations.

Looking at the drivers by strategy from our GP survey, it is not surprising that leverage contributes to the returns of buy-out funds more than to other strategies (although they claim only 13% on average) and growth funds derive most of their return from EBITDA improvement. Furthermore, it is interesting that buy-out funds profited the most from multiple expansions. As mentioned before, strategy-agnostic funds are hard to distinguish from buy-out funds.

\(^{37}\) Often EBITDA is used as a proxy for cash flow.
Analysing the exit routes by type of firm, we noticed that buy-out funds typically exit via trade sales, while growth funds and strategy-agnostic funds take the IPO route (close to 50% of the respondents).

Asia still sees very little activity in secondary market (i.e. sale to another PE investor). “Other” is a significant exit option and includes a range of structures, e.g. a sale-back to the original owner or a secondary placement on an exchange.

Write-offs at only 5% appear to be underreported, with many GPs claiming none, although we have anecdotal evidence of write-offs for some of these funds. It may be that those cases were not considered “proper exits” and therefore omitted.

Reasons given for the few write-offs mentioned frequently included operational underperformance, both for company specific reasons and due to an adverse macro-economic environment. In a few cases, too much leverage for the current environment or a deal structure not robust enough were mentioned. Interestingly, conflicts with partners such as management or co-shareholders, or other control issues often mentioned in the press and industry circles, were never given as a reason for the write-off.

Answers to our questions about other return drivers such as the proportion of competitive deals (relatively low with average of 26%) or control deals (close to 100% for buy-out funds and close to 0% for growth funds, with agnostic funds in between) contained few surprises.

**Summary Findings**

> In our independent surveys, LPs and GPs perceive value drivers in Asian PE remarkably different: LPs over-emphasise multiple expansion and debt reduction; GPs claim improvements in operating profitability to be the main driver across fund types, including those focused on developed Asia and buy-outs.

> A wide range of exit options is utilised, with IPOs being the main route for growth funds and trade sales for buy-out funds. Few sales to other financial investors or write offs are mentioned.
4.5 Outlook

We also asked our survey respondents to share their views on the future growth and performance of Asian private equity.

First, we asked our respondents how they expect factors relevant to PE to evolve over the coming years. Due to the different dynamics, we asked the question for both developed and developing Asia.

Figure 31: Outlook on Several Dimensions for Developed Asia by LPs and GPs

For developed Asia, both LPs and GPs expect multiples to remain stable; yet a higher proportion of GPs expect a potential uptick, while 25% of LPs see potential for multiple contractions.

LPs have no conclusive view on availability of debt and development of pricing/terms, while GPs mostly expect it to remain at current levels or even get better. Control deals are expected to remain a strong and growing feature in developed Asia. There is disagreement on changes in the regulatory environment, with LPs markedly more pessimistic than GPs (perhaps influenced by a wider global perspective?).

Overall, LPs expect multiples in developing Asia to come down, or at best stay at current levels. GPs are considerably more optimistic, with only 27% expecting them to drop compared to 50% of the LPs. But our GPs are more hesitant when asked about better access to debt and larger number of control deals. Here, our LPs clearly expect the industry to move in the direction of the developed Asia model. Both LPs and GPs share similar views on the regulatory environment, with about two-thirds expecting an improvement, in stark contrast to their expectations for developed Asia.

Figure 32: Outlook on Several Dimensions for Developing Asia by LPs and GPs

22 While LPs generally had a view on both developing and developed Asia, GPs often limited their answers to geographies where they had firsthand investment experience, e.g., a GP only investing in Japan would answer questions on developed Asia only from a Japanese perspective and provide no answers at all on developing Asia.
Then we asked about their expected growth rate for the industry as benchmarked against the 20% p.a. of recent years. About two-thirds of the LPs expect the growth rate to be above the historic average. This is more optimistic than the GPs surveyed, who mostly see growth remain at historic levels.

These answers are particularly intriguing when we compare them to the graphs below that show their forecasts of Asian PE returns over the next 5-10 years. They are mirror images of each other, with the GPs taking the bullish, and the LPs the bearish view on future trends.

Thus the group that is more optimistic on returns (GPs) sees the asset class growing more slowly than the group (LPs) that is more pessimistic on returns. From the perspective that money typically flows where it expects the highest returns, this seems counterintuitive. However, one might suggest that the lower/higher expected growth rate of the industry will lead to higher/lower returns due to lower/higher competition.

**Summary Findings**

> LPs and GPs expect little change in drivers of PE for developed Asia, with some increase in control deals and availability of debt. LPs are relatively more cautious on multiple expansion and regulatory development.

> For drivers of PE in developing Asia, LPs are wary of multiple contractions but overall more optimistic than GPs on the increasing role of debt and control deals. Both groups see a favourable regulatory environment ahead.

> Two-thirds of our LPs expect a faster growth of the asset class, with the majority of GPs expecting it to remain at historic levels. Yet both groups hold mirror views on future returns of Asian PE with most GPs optimistic and most LPs bearish.
4.6 Portfolio Allocation Plans

In this last chapter, our surveyed LPs' feedback on their portfolio allocation plans, as well as comment on the status of GP-LP relationships in Asia.

Figure 35: Planned Changes in Allocation to Asian PE over Next 12-24 Months by Surveyed LPs

In line with their expectation for strong growth in the asset class most LPs surveyed plan to increase their allocation to Asian private equity over the short term.

While overall no LP interviewed plans to lower his allocation to Asia, certain strategies and geographies are expected to see some recalibration.

Figure 36: Planned Changes in Allocation by Strategy and Geography over Next 12-24 months

Most LPs plan to increase their allocation to funds with growth strategies but are divided about buyout funds, with the majority planning to remain unchanged. As for geographical allocations, there is a clear trend away from developed Asia towards developing Asia, with the majority of our LPs planning to increase exposure to Greater China and India, while reducing allocations to Japan/ Korea and Pan-Asian funds (all relative, not absolute).

Of course, in addition to the prospects of returns, these allocation decisions also take investors’ major concerns about investing in Asian PE into account.

Figure 37: LPs Biggest Concerns when Investing in Developed (left) and Developing Asia (right)
Developed Asia will see a de-prioritising partially because of a perceived capital overhang, worries about returns suffering from strong competition, high valuations, and the reduced availability of credit, one of its main return drivers. High valuations/high prices are the main concern in developing Asia, followed by several risks on the GP side such as team stability, inexperience and lack of strategic focus (also referred to as style drift or opportunistic investing).

On the topic of GP-LP relations, we asked our LPs what percentage of their existing relationships they are currently unlikely to renew. LPs show a high degree of dissatisfaction with a fairly large number of their existing GPs. On average, investors would not renew 27% of their existing relationships. The LPs surveyed appear to be quite strict, with answers ranging from 0% all the way to 50%! The main reasons provided for not renewing are poor returns, followed by team issues and strategy drift.

Interestingly, these issues were rarely a discussion topic for our “top GPs”. Only fund size reduction featured in their replies—a reflection of the above-mentioned fear of too much capital for the opportunities available and potentially a belated LP reaction to the fast increase in fund sizes mentioned earlier. Instead, several of the globally discussed topics came up in conversations between GPs and their backers. Most LPs were interested in co-investments. Increased transparency was also mentioned, as were key terms. Somewhat surprisingly, management fee reduction was not a (acknowledged) topic, perhaps because Asian GPs still require investment to build their firms.

Summary Findings

- Most LPs will increase their allocation to Asian PE. There is a focus on growth funds and a trend towards developing Asia. The majority of LPs plans to increase relative exposure to Greater China and India, while reducing Japan/Korea and Pan-Asian funds.

- LPs are mostly worried about too few opportunities in developed Asia, high prices/valuations, and a range of GP team issues in developing Asia.

- Besides poor returns, team issues also feature as the main reason for LPs to discontinue investing with their existing GP relations. Currently LPs would on average not renew a high 30% of present relationships.
5 Conclusions

We set out to look at the maturity of private equity in Asia through the eyes of some of the largest and most experienced LPs investing in this region.

Interest in Asian Private Equity is strong as investors look to participate in the macro-economic growth story of the region resulting in large fund inflows. Yet investing in Asian PE is not a low-risk strategy. Historically, over a ten year horizon, average returns for the asset class have not been very high. While they have been improving in recent years many of these returns are still unrealised which is especially relevant as the industry has more than doubled in size over the last five years. Furthermore the dispersion between Asian fund managers’ returns has been significantly higher than in Western private equity, creating a high-risk for concentrated portfolios of private equity investors. Then again, this higher variance also includes top quartile fund managers who have outperformed their Western counterparts in absolute returns, making manager selection even more important in Asian private equity than in the developed markets.

We surveyed a group of top institutional LPs that deal with these issues on a regular basis. As a group they have been investing in Asian private equity on average since 2001, allocating more than $9.4 billion or 9.4% of their global PE assets of $100 billion to the region. Institutional investors’ return expectations for private equity from developing Asia are about 0.65x invested capital higher than for Western private equity (corresponding to approximately 6.5% IRR). Yet LPs do not expect much of a risk premium for private equity from developed Asia. Depending on an investor’s portfolio mix between developed and developing Asia, the expected gross multiple return therefore lies between 2.0x and 2.6x invested capital (i.e. for a 50:50 split the expected return would be 2.3x).

Looking at their present portfolios, our LPs expect on average a yield of 2.1x, just short of their self-announced target rate. Our investors mostly have a diversified portfolio that shields them from underperformance by any specific manager, strategy, geography or vintage. Yet while confident in their current portfolios, the majority of LPs expects returns for the asset class overall to come down in the coming years. This might in part be a reflection of their strong belief that the asset class will exceed its already solid historic growth rate, with the large inflow of capital diluting average returns. Then again, our surveyed LPs will be part of the trend and are planning to allocate more to Asian private equity. It remains to be seen whether they will be able to continue selecting high-performing managers.

Strategically, most of our surveyed LPs will shift focus and increase allocations to developing Asia, de-emphasising developed Asia and Pan-Asian funds (in relative, not absolute, terms). Tactically, they will thoroughly evaluate their current relations, with on average 27% of GP relationships facing the risk of not being renewed. This is driven by unsatisfactory returns and unhappiness about internal issues on the GPs’ side (mostly team issues), but is also prompted by the expectation of being able to find better performance elsewhere in a broadening and maturing market.

In our second survey we approached a pool of top GPs which, as a group with an NAV of their mature funds of 2.3x, have historically outperformed the industry average and delivered better returns than the surveyed LPs’ portfolios. These GPs have raised $26 billion over the last eight years – a sizable amount and a significant proportion of the total amount invested in Asian private equity during that period. They have also been able to raise increasingly large funds within short time intervals.

They have done so on the back of a strong performance derived (as they state) mostly from operational improvements rather than leverage or multiple expansion – independent of the funds’ geographical focus and investment strategy. This is very different from the perception that our LPs have (again, of the asset class overall). Possibly influenced by their own track record, these GPs also take a more positive view on the development of returns for the asset class than the LPs surveyed. At the same time they expect the industry to grow more steadily than our more optimistic LPs.

If this vision of the future holds true, a steadily growing industry with strong returns resulting mainly from creating better and stronger companies, then Asian private equity will truly have come of age.
6 Respondents Breakdown

“The INSEAD-AXA Private Equity Survey approached the top 30 LPs and top 50 GPs active in Asia to canvass their plans and opinions on the PE market in the region. The survey does not attempt to showcase the average performance of the asset class, nor does it try to identify top quartile/decile performance ex post. Instead, we concentrated on the most sophisticated institutional investors (LPs) and their real-life portfolios with the managers (GPs) they selected and who will strongly influence their performance for years to come.

Our LP respondent’s composition follows broadly that of other (larger) surveys\(^3\) on emerging market LPs, except for the significantly higher proportion of funds of funds and the absence of development institutions. This follows from our focus on a select small group (top 30) of the largest, most sophisticated and return-driven investors. The LPs as a group started investing in Asian PE on average in 2001. Excluding the sovereign wealth fund that did not provide detailed data, respondents manage about $100 billion in allocations to PE worldwide. Of this, 9.4% or $9.4 billion are allocated to Asia. The average allocation is $670 million, while the median stands at $450 million.

A third of funds financed are Pan-Asian, with other large blocks in North Asia (Japan/Korea and China). In terms of dollar allocations, Pan-Asian funds take an even larger share, driven by the largest average commitment per fund of $34 million, while funds from South East Asia, India and China have comparatively smaller fund allocations, on average ranging from $17 million to $20 million per fund.

\(^3\) For instance, compare with Coller Capital, & EMPEA (2010).
Our GP respondent’s composition by strategy is balanced between buy-out, growth and agnostic. We cover 57 funds among the GPs with average fund size of $600 million and median of $400 million. Fund sizes have trended up strongly over time, from an average of $150 million three fund generations ago to an average of $1 billion per fund.

Geographically funds are well balanced, with Japanese and Pan-Asian funds larger than average therefore accounting for a larger share of overall dollars.
7 References


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